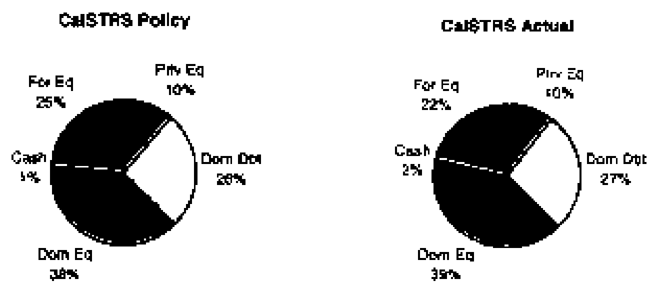
PENSION CONSULTING ALLIANCE, INC.

The CalSTRS investment portfolio declined by $9.8 billion over the past year ending with a value of $102.8 billion on June 30, 2001. As highlighted below, the CalSTRS portfolio is broadly diversified, holding investments ranging from publicly-traded short-term bonds to privately-held partnerships. Clearly, the scale and breadth of investments make the management and oversight of these assets highly complex. In light of these factors, CalSTRS has been effective in using its resources in a cost-efficient manner to ensure that benefits continue to flow to CalSTRS participants.

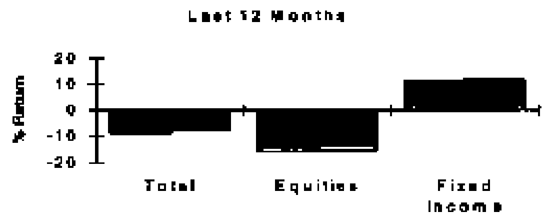
Investment Allocation

The most critical factor influencing overall investment performance is the allocation of the CalSTRS portfolio across major asset classes. The second quarter report reflects asset allocation guidelines adopted by CalSTRS on January 1, 1999 (see left pie chart). The portfolio's actual allocation is modestly different from policy. Foreign equity is slightly underweighted while domestic debt, domestic equity and cash are slightly overweighted (see right pie chart).

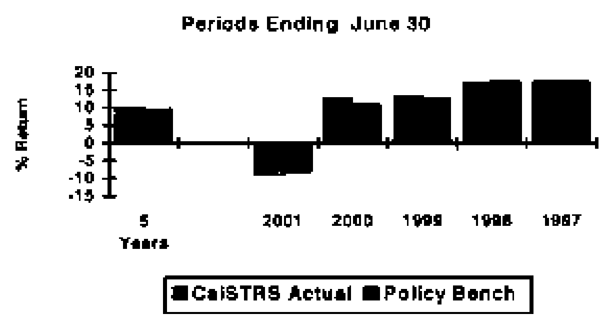


Investment Results

Over the last year, the CalSTRS investment portfolio produced an overall return of minus (9.1%) ranking in the fourth quartile among its large public pension fund peers[1] (top bar chart). The portfolio underperformed policy by approximately one percent (1.0%) largely due to relative underperformance of the Fund's private investments.[2]



During the last three years, CalSTRS' portfolio generated a 5.1% return (second quartile vs. peer funds) compared to 4.6% for the policy benchmark. Over the last five years, the CalSTRS investment portfolio produced an average annual return of 9.8%, exceeding its policy benchmark by 30 basis points (bottom chart). Successive one-year periods are shown as well. For periods ending June 30, CalSTRS' portfolio has outperformed its policy benchmark in three of the latest five one-year periods.[3]



Pension Consulting Alliance, Inc.

---

1 Per TUCS Universe for Public Funds with assets in excess of $1 billion.

2 The policy benchmark consists of passively managed asset class portfolios weighted by CalSTRS' policy allocations. The difference between actual results and the benchmark are due to two factors: i) deviations from policy and ii) active decisions on the part of CalSTRS and its investment managers.

3 CalSTRS' investment performance is calculated using a monthly internal rate of return and day-weighted cash flows. Periods longer than one month are geometrically linked. This method of return calculation complies with AIMR performance presentation standards.

With the decline in the domestic and international equity markets, the market value of the CalSTRS investment portfolio declined to $102.8 billion on June 30, 2001. While the past year was disappointing it was not unexpected. The investment portfolio had experienced an historic run of six straight years of double-digit returns. The investment performance of the past year must be viewed within the context of the past three and five years. As a perpetual defined benefit plan, CalSTRS has a very long investment time horizon. Individual year performance is not as meaningful as the overall performance over a longer period of time.

Over a three-year period, the portfolio grew by $14.5 billion. This dollar gain represented a return of nearly 5.1 percent, outperforming its benchmark by more than 50 basis points, adding more than $500 million to the fund. Several asset classes exceeded their benchmarks, with exemplary performance shown by the Domestic and Private Equity segments. These strong results allowed CalSTRS portfolio to finish in the top third of its peer group of large public funds. At the end of the last fiscal year, CalSTRS portfolio allocation across asset classes was as follows: U.S. and non-U.S. Equity, 61 percent; Fixed Income, 27 percent, Private Equity, 10 percent and short-term investments (cash), 2 percent.

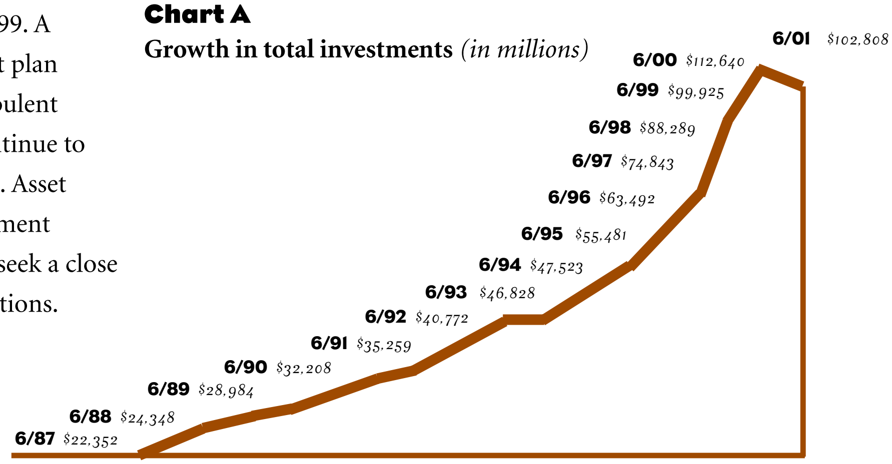
CalSTRS continues to follow its established long-term strategies. The results achieved over the past three years reaffirmed the asset allocation decisions made by the Teachers' Retirement Board in 1997 and 1999. A consistent and well thought-out investment plan provides stability and direction during turbulent market conditions. The board and staff continue to focus on the long-term investment horizon. Asset allocation is the critical driver of the investment returns. As such, CalSTRS will continue to seek a close alignment between policy and actual allocations.

Chart A, illustrates the growth in the total investment portfolio, excluding securities lending collateral, over the past 15 years. Chart B compares CalSTRS' returns with the actuarial rate, which is the long-term assumed rate of return for the fund. Chart C shows the performance returns for all of the asset classes in the portfolio and the benchmark indices. The return calculations are consistent with Association for Investment Management and Research performance presentation standards. These returns are shown over 1, 3, 5, and 10-year periods.

Benchmark Modification

During the fiscal year, the CalSTRS Investment Committee reviewed and approved the Benchmark Modification Policy. This policy is intended to modify CalSTRS benchmarks when it is deemed in the best interest of the fund. The practical effect of this review was to change the benchmarks for all passively managed accounts, both domestic and international, to tobacco-free benchmarks. The tobacco free indices were adopted in September 2000.

Chart A
Growth in total investments *(in millions)*



Asset Allocation (6/30/01)
Total investment portfolio of $102.8 billion

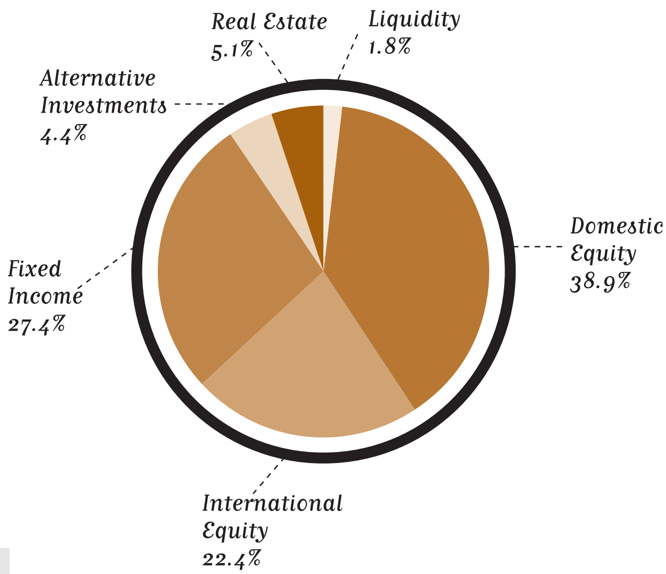


Chart B
Growth in CalSTRS' returns *(percent)*

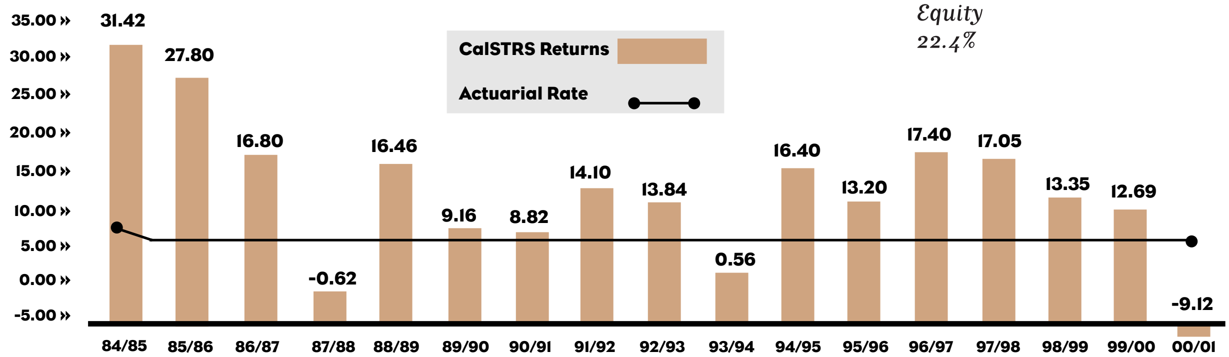


Chart C
Performance returns for major asset categories

Portfolio Type / Associated Indices	1 Yr	3 Yr	5 Yr	10 Yr
Total Fund	-9.12	5.10	9.79	10.63
Domestic Equity	-14.80	4.03	13.06	14.48
Russell 3000 *	-14.44	4.04	13.63	14.90
Wilshire 5000	-15.32	3.51	13.07	14.57
International Equity	-22.45	1.09	3.67	N/A
MSCI All Country Free ex US (G) *	-24.20	-0.65	2.56	6.42
MSCI Europe, Australia & Far East *	-23.62	-1.25	2.88	6.38
MSCI Emerging Market Free *	-26.21	1.30	-6.50	4.77
Fixed Income	11.44	5.62	8.16	8.84
Salomon LPF	11.82	5.70	7.94	8.75
Real Estate	13.84	14.62	14.82	7.29
Real Estate Custom **	11.57	11.96	12.19	6.96
Alternative Investments	-14.54	21.13	26.35	21.02
Alternative Investments Custom ***	4.44	9.85	11.58	N/A
Liquidity	6.95	6.39	6.28	5.72
Salomon 3-Month Treasury Bill	5.64	5.22	5.23	4.80

* *CalSTRS adopted tobacco free indices beginning 9/1/00*
** *NCRIEF after 7/1/97 and Institutional Property Consultants prior to 7/1/97; lagged 1 quarter*
*** *Blend of the [Russell 3000 + 5% + 90 day T-Bill] after 4/1/99 and [CPI + 12%] prior to 4/1/99; lagged 1 quarter*

Objectives

The core objectives of the Investment Management Plan remained unchanged. The primary objectives are set forth in the California Constitution and the California Education Code. The foremost objective is to provide for present and future benefit payments, then to diversify the assets, and finally, endeavor to reduce CalSTRS funding costs. Additionally, the board and staff strive to run the investment program in such a manner so as to maintain the trust of the participants and public.

Fixed Income

The Fixed Income unit is responsible for the internal management of CalSTRS fixed income assets, totaling approximately $28 billion in market value. As of June 30, 2001, the Treasury/Agency portfolios represented a majority of the assets, with $10.0 billion. The High-Grade Corporate bond portfolio with $9.2 billion, and the Mortgage Backed Securities portfolio with $8.8 billion in assets, completed the balance of the fixed income portfolio. For the fiscal year ended June 30, 2001, the long-term fixed income portfolios trailed the performance benchmark return by 38 basis points.

The Fixed Income unit also manages a short-term portfolio, known as the Liquidity Portfolio, which is utilized for cash and liquidity purposes. This portfolio had approximately $1.9 billion in assets at fiscal year end. While CalSTRS long-term goal is to be fully invested at all times, benefit payments and asset allocation decisions necessitate having short-term highly liquid assets that provide a competitive rate of return until re-deployed into other asset classes. The Liquidity Portfolio exceeded its performance benchmark return by over 100 basis points for the fiscal year ended June 30, 2001.

Three other programs are also managed by the Fixed Income unit: the Home Loan Program, the Currency Hedging Program, and the Securities Lending Program.

Chart D

Largest fixed income holdings as of June 30, 2001 *(CalSTRS maintains a complete list of portfolio holidings)*

Issue	Maturity Date	Interest Rate	Par	Market Value	Average Cost	Unrealized Gain/(Loss)
US TREAS BDS	15-Feb-20	8.50%	485,000,000	626,333,850	584,763,730	41,570,120
US TREAS BDS	15-Aug-17	8.88%	460,000,000	603,823,600	512,510,179	91,313,421
US TREAS BDS	15-Aug-19	8.13%	473,000,000	588,955,950	491,618,616	97,337,334
US TREAS BDS	15-Feb-19	8.88%	420,000,000	556,500,000	455,474,268	101,025,732
US TREAS BDS	15-May-17	8.75%	414,000,000	537,231,240	428,303,362	108,927,878
FED HOME LN MTG CORP	15-Mar-09	5.75%	480,500,000	472,614,995	432,072,145	40,542,850
US TREAS BDS	15-Nov-18	9.00%	305,000,000	407,986,300	380,324,165	27,662,135
US TREAS BDS	15-Nov-16	7.50%	325,000,000	378,625,000	332,940,846	45,684,154
US TREAS BDS	15-Aug-15	10.63%	250,000,000	365,390,000	351,954,974	13,435,026
US TREAS BDS	15-Feb-15	11.25%	235,000,000	355,583,200	335,135,432	20,447,768

Chart E

Largest equity holdings as June 30, 2001 (CalSTRS maintains a complete list of portfolio holdings)

Issue	Shares	Market Value	Average Cost	Unrealized Gain/(Loss)
General Electric Co.	28,382,794	1,383,661,208	357,541,421	1,026,119,786
Microsoft Corp.	15,262,795	1,114,184,035	383,574,917	730,609,118
Exxon Mobil Corp.	9,719,295	848,980,418	359,799,493	489,180,925
Citigroup Inc.	14,664,592	774,877,041	235,663,855	539,213,186
Pfizer Inc.	18,521,289	741,777,624	264,520,611	477,257,013
AOL Time Warner Inc.	12,609,522	668,304,666	234,379,001	433,925,665
Wal Mart Stores Inc.	12,749,536	622,177,357	170,607,147	451,570,210
International Business Machines	5,121,662	578,747,806	214,051,811	364,695,995
Intel Corp.	19,461,670	569,253,848	208,807,388	360,446,459
American Intl Group Inc.	6,520,025	560,722,150	127,937,435	432,784,715

Home Loan Program

The CalSTRS Board has been working with staff over the past couple of years in order to revitalize and update the Home Loan Program to reflect changes in the mortgage loan market. During the last fiscal year CalSTRS funded over $350 million in home loans, representing a five-fold increase from the previous year. Given the success of the program, staff will continue to pursue opportunities to further enhance the Home Loan Program by streamlining and automating the current process.

Currency Hedging Program

The strategic objective for the Currency Hedging Program is to reduce the risk of the passively managed segment of the international equity portfolio. CalSTRS has the ability to hedge a portion of its international stock exposure in order to protect these assets against a strengthening U.S. dollar in both Asia and Europe. This program has been successful in adding value as a result of its prudent use of basic hedging principles and the strength of the U.S. dollar overseas. To date, the Currency Hedging Program has generated more than $575 million in additional income to the fund.

Securities Lending Program

CalSTRS has been lending securities since 1988; this represents CalSTRS first and longest running extra income program. The Program was designed to enable CalSTRS to use its existing asset base and investment expertise to generate additional income. The amount of income that is earned as a result of the Securities Lending Program is based upon a number of factors. These factors include the type and amount of stocks and bonds held by CalSTRS, the volume of securities loaned, the appetite of the financial markets for CalSTRS inventory of securities, and the reinvestment of the cash taken in as collateral. Over the last fiscal year, CalSTRS has earned approximately $70 million from this activity; since inception, the program has earned nearly $420 million.

Internal Equity Management

During the fiscal year ended June 30, 2001, the Investment Committee changed the investment benchmark to exclude tobacco stocks for the internally managed passive portfolio. The performance objective of the portfolio is to closely track the return of the S&P 500 ex-Tobacco Index. As of June 30, 2001, the portfolio had a market value of $13.2 billion. For the twelve-month period

Chart F

Investment summary for the year ended June 30, 2001 *(in millions)*

	30-Jun-00		30-Jun-01			
Portfolio Type	Book Value	Market Value	Book Value	Market Value	% of Market Value	Net Market Change
Domestic Equity	22,477	46,982	23,587	39,951	38.86%	-7,031
International Equity	21,922	28,546	22,829	22,984	22.36%	-5,562
Fixed Income	27,694	27,312	27,498	28,217	27.45%	905
Alternative Investments	3,300	5,132	3,987	4,515	4.39%	-617
Real Estate	3,943	3,772	5,257	5,274	5.13%	1,502
Liquidity	896	896	1,867	1,867	1.82%	971
Total Portfolio	80,232	112,640	85,026	102,808	100%	-9,832
Plus: Securities Lending Collateral		16,107		17,728		
Less: Accruals		1,320		381		
Plan Net Assets–Investments		127,427		120,155		

Chart G

Schedule of fees July 1, 2000 through June 30, 2001 *(in thousands)*

	Assets Under Management	Fees	Basis Points
Investment Managers' Fees:			
Domestic Equity	$46,982,198	$10,261	2.2
International Equity	28,563,905	31,673	11.1
Alternative Investments	5,131,705	1,163	2.3
Real Estate	3,771,560	12,844	34.1
Total Investment Managers' Fees	**$84,449,368**	**$55,941**	**6.6**

ended June 2001, the portfolio returned –15.38 percent, meeting its objective to closely track the index.

The Cash Equitization Program enables CalSTRS domestic equity exposure to remain closer to the board-approved strategic asset allocation policy target. The program seeks to achieve the total return of the S&P 500 Index by holding S&P 500 futures contracts or other similar securities, backed by a portfolio of short-term fixed income securities. As of June 30, 2001, the program had a market value of $123 million. For the twelve-month period ended June 2001, the program returned –14.59 percent, outperforming its benchmark of the S&P 500 Index by 0.23 percent (23 basis points).

Alternative Investments

The Alternative Investments asset class invests in the private equity universe. These investments involve companies that are not publicly traded and normally require active involvement by the external equity managers hired by CalSTRS. The vast majority of these investments are made through limited partnership portfolios, which consist of pools of investments.

This fiscal year, CalSTRS made additional commitments of approximately $1.9 billion in this segment of the portfolio. Total commitments now amount to approximately $10.0 billion. There are 115 partnerships and 14 co-investments in the Alternative Investment portfolio. At the end of the fiscal year, the total market value was $4.5 billion, representing approximately 4.4 percent of the total CalSTRS portfolio. CalSTRS continues to increase its commitments in this area as a result of the allocation review completed at the end of June 1999. The Alternative Investment asset class has achieved annualized returns of –14.5, 21.1, and 26.4 percent, for the 1, 3, and 5 year periods respectively.

Credit Enhancement

CalSTRS has a credit rating of AAA/Aaa/AAA by Standard and Poor's, Moody's Investors Service, and Fitch Inc. This rating is utilized by issuers of municipal debt in California to assist in the issuance of variable rate municipal bonds. CalSTRS enters into agreements with a number of issuers of tax-exempt debt to provide the payment of principal and interest in the event of a non-payment and/or marketing support in the capital

Chart H

Broker commissions *(July 1, 2000 through June 30, 2001)*

Broker Name	Commission	Shares	Commission per Share
Domestic Equity Transactions			
Jackson Partners + Associates Inc.	667,161	11,997,181	0.056
Instinet	560,921	24,464,065	0.023
Lehman Bros Inc.	532,444	15,210,748	0.035
Investment Technology Group Inc.	397,867	22,814,269	0.017
Morgan Stanley and Company, Inc.	397,614	10,470,969	0.038
Capital Institutional Services	371,681	6,695,470	0.056
CS First Boston Corporation	337,348	8,305,805	0.041
Prudential Securities Incorporated	277,117	7,516,396	0.037
Spear, Leeds & Kellogg	221,016	4,246,043	0.052
Abel Noser Corporation	219,826	4,412,450	0.050
Other Domestic	2,137,216	45,204,481	0.047
Total Domestic Commissions	**6,120,209**	**161,337,877**	**0.038**
International Equity Transactions			
Morgan Stanley and Company, Inc.	2,624,480	279,393,545	0.009
Merrill Lynch	1,350,266	236,077,857	0.006
Lehman Brothers Securities	1,209,829	587,325,518	0.002
CS First Boston Corporation	888,282	688,180,664	0.001
Credit Lyonnais	486,328	2,386,854,547	0.000
HSBC Investment Bank Plc	390,992	30,782,902	0.013
J.P. Morgan Securities Ltd	243,952	36,987,711	0.007
Nomura Securities Company	207,815	5,599,147	0.037
Saloman Brothers Inc.	194,862	14,944,602	0.013
SBC Warburg	184,329	1,889,251,644	0.000
Other International	1,894,635	142,320,132	0.013
Total International Commissions	**9,675,770**	**6,297,718,269**	**0.002**

markets. In return, CalSTRS earns fee income for these commitments. Most the transactions are supported by banks or bond insurers for repayment. As of June 30, 2001, the Credit Enhancement Program had commitments of approximately $1.2 billion and fee income earned during the fiscal year was more than $2.8 million.

Real Estate

During the past fiscal year, CalSTRS portfolio of real estate assets reached $5.3 billion. The real estate portfolio is comprised of 102 directly owned properties and investments in five opportunity funds. Twenty-six directly owned assets were purchased while six assets were sold during the year. CalSTRS also committed capital to two additional opportunity funds. Real Estate assets are 5.1 percent of the total fund and met the funding allocation at June 30, 2001. The direct property portfolio is diversified as to property type and geographic location. The largest component of the direct property sector is office buildings, with the largest weighting in the western region of the United States. The CalSTRS Real Estate portfolio has achieved gross annualized returns of 13.8, 14.6 and 14.8 percent, for the 1-, 3- and 5-year periods, respectively. CalSTRS return exceeded the NCREIF benchmark by 2 percent for each of the 1-, 3- and 5-year periods.

External Equity Management

During 2001, the Public Equity portfolio, which is comprised of both internally and externally managed portfolios, continued to be an important investment vehicle to the fund. In fiscal year 2000-01, this segment of the portfolio accounted for about 61 percent (or $62.9 million) of the total fund. Domestic Equity accounted for 39 percent of the total equity allocation, while International Equity accounted for the remaining 22 percent.

The External Equity portfolio is managed by 19 external domestic managers and 20 external international managers. Although the equity markets were extremely volatile, CalSTRS domestic active managers slightly underperformed their benchmark by 36 basis points; however, CalSTRS international active managers continued to add value by outperforming their benchmark by 175 basis points.

Corporate Governance

During the 2000-01 fiscal year, CalSTRS voted on a variety of proxy issues including financial, corporate governance and social issues. More than 5,900 votes were cast on proxy issues of corporations whose shares were owned in the Investment Portfolio. These proxy issues were presented on 2,314 companies. The overall number of proxy issues decreased from 7,192 last year, but the number of mergers/acquisitions reviewed remained constant, at a little under 10 percent.

The major issues voted are summarized below:

1. Election of Directors: CalSTRS generally votes in favor of directors unless the proxy statement shows circumstances contrary to policy. Examples of such circumstances are: greater than 50 percent board representation by company executives, potential conflict of interest due to other directorships or employment, and classification of the company directors.

*Number Voted: **2,097***
*For: **1,767***
*Against: **330***

2. Selection of Auditors/Accountants: CalSTRS generally votes in favor of the independent auditors and accountants recommended by management.

*Number Voted: **1,328***
*For: **1,328***
*Against: **0***

3. Compensation Plans: (Stock Options, Incentive Stock Options, Employee Stock Purchase Plans, etc.) Corporations provide a variety of compensation plans to keep executives, employees, and non-employee directors. A number of these plans provide for the issuance of long-term incentives to attract, reward, and retain key employees. Compensation plans are evaluated based on CalSTRS Financial Responsibility Criteria.

Number Voted: 804
For: 287
Against: 517

4. Approve Merger/Acquisition-Management: CalSTRS generally votes in favor of the acquisition or merger of one company into another.

Number Voted: 203
For: 203
Against: 0

5. Corporate Actions/Corporate Governance Issues: These are issues related to mergers, acquisitions, stock issuance, stock splits and incorporation. CalSTRS generally votes in favor of these proposals unless there is a compelling reason not to cast a positive vote.

Number Voted: 279
For: 46
Against: 233

6. Other—Miscellaneous—Management: CalSTRS generally votes in favor of other miscellaneous business recommended by management, but issues are decided on a case-by-case basis.

Number Voted: 348
For: 306
Against: 42

Cash Balance Benefit Program

The Cash Balance Benefit Program contributions are invested at the direction of the Teachers' Retirement Board in internally pooled portfolios of the Teachers' Retirement Fund. Sixty percent of the contributions are allocated to the S&P 500 portfolio and 40 percent to the Government Index portfolio.

Contributions in the CB Benefit Program began on February 1, 1997. The investment value of those contributions as of June 30, 2001, is $15.3 million. For both portfolios, the combined total return for the past year was –5.3 percent. Since their inception, these portfolios have achieved a return of 11.8 percent.

Defined Benefit Supplement Program

The Defined Benefit Supplement Program contributions are invested in the Teachers' Retirement Fund Excluding Private Equity (Alternative & Real Estate Investments). Contributions were first received in the DBS Program in January 2001. The investment value of those contributions as of June 30, 2001, is $210.0 million. Since the inception of the DBS Program, the cumulative rate of return was –5.1 percent.